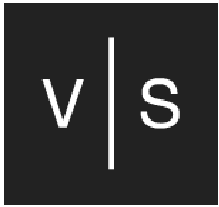

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IN THIS ISSUE:

PINE OAK BUILDERS V. GREAT AMERICAN LLOYDS:

The Supreme Court, in one opinion, reaffirms *Lamar Homes*, *Don's Building* and *GuideOne*

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Pine Oak Builders v. Great American Lloyds: Supreme Court Refuses to Apply an Exception to the "Eight Corners" Rule

On February 13, 2009, the Supreme Court of Texas issued another important opinion for insurance law jurisprudence. *See Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, No. 06-0867 (Tex. Feb. 13, 2009). First, the Court applied its prior decision in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007), finding that faulty workmanship claims can allege "property damage" caused by an "occurrence" and the Prompt Payment of Claims Act applies to an insurer's breach of its duty to defend its insured under a liability policy. Second, the Court also applied its recent decision in *Don's Building Supply, Inc. v. OneBeacon Insurance Co.*, 267 S.W.3d 20 (Tex. 2008), remanding the case to the trial court so that it can apply the actual-injury rule to determine whether the property damage claims fall within the insurers' policies. Third, and most importantly, the court addressed the ongoing debate regarding the use of extrinsic evidence to determine an insurer's duty to defend its insured. Again, the Court acknowledged its holding in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), in which it rejected an exception for "overlapping" facts. It applied that same finding to the issues before it and found that extrinsic evidence could not be admitted and that Pine Oak Builders was not entitled to a defense from its insurer for the claims asserted against it by one of five separate plaintiffs.

A. Background Facts

Pine Oak, a homebuilder, was insured by Great American under consecutive, occurrence-based commercial general liability insurance policies covering April 1993 to April 2001. Mid-Continent Casualty Co. issued similar policies from April 2001 to April 2003.

During a one-year period from February 2002 to March 2003, five homeowners sued Pine Oak in separate lawsuits, alleging that their homes suffered water damage as a result of defective construction. Four of the lawsuits claimed that the improper installation of an Exterior Insulation and Finish System ("EIFS") caused the damage,

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while the fifth lawsuit, the *Glass* lawsuit, alleged that the damage was caused by the improper construction of columns and a balcony.

Great American and Mid-Continent refused to defend Pine Oak, so Pine Oak filed a declaratory judgment action against them both. The insurers counterclaimed and all parties moved for summary judgment. Pine Oak urged a finding that it was entitled to a defense and damages. Great American argued that its policies did not cover the claims in the underlying lawsuits and Mid-Continent argued that its EIFS exclusion barred coverage. The trial court ruled in favor of the insurers on all the motions, and the court of appeals affirmed as to Mid-Continent because of the application of its EIFS exclusion. With regard to both insurers, the appellate court affirmed the trial court's ruling on the *Glass* lawsuit given the absence of any allegation that a subcontractor performed the work, but concluded that Great American owed a defense on each of the other four underlying lawsuits. The appellate court ruled that notwithstanding Great American's improper denial of defense, Pine Oak was not entitled to statutory damages.

Happy Friday the 13th

B. *Lamar Homes* Applies

At the outset, the Supreme Court of Texas said that *Lamar Homes* foreclosed Great American's argument that the faulty-workmanship claims asserted against Pine Oak did not constitute "property damage" caused by an "occurrence." *Id.* at 3. The Court said that the relevant language in Great American's policy was identical to that addressed in *Lamar Homes*. *Id.* In addition, the Court agreed with Pine Oaks that *Lamar Homes* also applied regarding the Prompt Payment of Claims Act. In particular, the Court found that the statute applies to Great American's breach of its duty to defend. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 5, 20).

C. *Don's Building Supply* Applies

Turning to the issue of whether Great American's policies were triggered by the allegations in the underlying lawsuits, the Court noted that the houses at issue were built in 1996 and 1997—during Great American's time on the risk. The appellate court applied the "exposure rule" in finding that the Great American policies were potentially implicated and thus owed a defense. Great American, in turn, urged the Supreme Court to apply the "manifestation rule," which could have precluded coverage in its entirety.

Of course, as discussed earlier in this paper, the Court already had rejected both such trigger rules in its decision in *Don's Building Supply*, adopting instead an "actual injury rule." Under that rule, "property damage occurs during the policy period if 'actual physical damage to the property occurred' during the policy period." *Pine Oak*,

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slip op. at 4 (quoting *Don's Building Supply*, 267 S.W.3d at 24). The Court noted that the policy language before it in *Pine Oak* was identical to the language addressed in *Don's Building Supply*, and thus, the same rule applied. As such, the Court ordered the trial court to apply the "actual injury rule" on remand "to any remaining disputes about whether the property-damage claims fall within the terms of the Great American policies." *Id.* at 5.

D. *GuideOne*, Extrinsic Evidence and the "Eight Corners" Rule

The final issue addressed by the Court involved the admissibility of extrinsic evidence regarding the *Glass* lawsuit in order to establish Great American's duty to defend. *Id.* The importance of the evidence stemmed from exclusion (l) of the CGL policy, which excludes property damage to the insured's completed work unless "the damaged work or the work out of which the damages arises was performed on your behalf by a subcontractor." *Id.* Thus, coverage depends, at least in part, on whether the defective work was performed by Pine Oak or a subcontractor. *Id.* (citing *Lamar Homes*, 242 S.W.3d at 11).

In four of the underlying lawsuits, the homeowners specifically alleged that the defective work was performed by subcontractors, but the *Glass* lawsuit omitted any reference to defective work performed by a subcontractor. Rather, Pine Oak was alleged to have failed to perform its work in a good and workmanlike manner and failed to make requested repairs. *Id.* In Pine Oak's lawsuit against the insurers, the company submitted extrinsic evidence that the work at issue was performed by Pine Oak's subcontractors, and thus it contended that Great American had to defend the company in the *Glass* lawsuit. *Id.* at 6.

The Court acknowledged that the duty to defend is determined by the "eight corners" of the insurance policy and the underlying pleading. It noted that its decision in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006), had been issued six days before the appellate court's ruling in the Pine Oak matter. In *GuideOne*, "[w]ithout recognizing an exception to the eight-corners rule, we held that any such exception would not extend to evidence that was relevant to both insurance coverage and the factual merits of the case alleged by the third-party plaintiff." *Pine Oak*, slip op. at 7 (quoting *GuideOne*, 197 S.W.3d at 309).

Applying that rule to the case before it, the Court found that Pine Oak's evidence contradicts the facts alleged in the *Glass* lawsuit. In particular, the plaintiffs in that case allege that Pine Oak constructed the columns and balcony at issue and that Pine Oak failed to perform its work in an good and workmanlike manner and failed to make

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repairs. *Id.* Such claims were barred from coverage by exclusion (l) of the CGL policy. Notably, "[f]aulty workmanship by a subcontractor that might fall under the subcontractor exception to the 'your work' exclusion is not mentioned in the petition." *Id.* "If the petition only alleges facts excluded by the policy, the insurer is not required to defend." *Id.* (quoting *Fid. & Guar. Ins. Underwriters, Inc. v. McManus*, 633 S.W.2d 787, 788 (Tex. 1982)).

Nevertheless, Pine Oak urged that the petition could be read to find that the culpable party in the *Glass* lawsuit was either Pine Oak or a subcontractor. Again, the Court disagreed. The petition in the *Glass* lawsuit, in contrast to the other four cases, did not allege faulty work by a subcontractor, did not allege that Pine Oak was liable for any subcontractor's work and did not allege negligent supervision of a subcontractor. *Id.* at 8. Rather, the petition alleged that Pine Oak—and only Pine Oak—was liable for its own actionable conduct. *Id.* The Court said that in "deciding the duty to defend, the court should not consider extrinsic evidence from either the insurer or the insured that contradicts the allegations of the underlying petition." *Id.* Because Pine Oak's evidence would have changed the allegations of the underlying lawsuit, it was inadmissible. "The policy imposes no duty to defend a claim that might have been alleged but was not, or a claim that more closely tracks the true factual circumstances surrounding the third-party claimant's injuries but which, for whatever reason, has not been asserted." *Id.* at 9. Because the duty to defend does not extend to allegations—true or false—that have not been made, Great American's duty to defend was not triggered by the *Glass* lawsuit. *Id.* at 10.

In finding that Great American did not owe a defense in that underlying lawsuit, the Court affirmed the appellate court's opinion. The appellate court had ruled that because no duty to defend existed, Great American also was not obligated to indemnify Pine Oak. Thus, in essence, the Court affirmed the holding that "no duty to defend means no duty to indemnify."

E. Different Case, Same Result

On the same day *Pine Oak* was decided, the Supreme Court of Texas also denied the petition in *D.R. Horton—Texas, Ltd. v. Markel International Insurance Company, Ltd.*, No. 06-1018 (Tex. Feb. 13, 2009). In that case, similar facts existed in that D.R. Horton was alleged to have performed faulty work related to masonry on a home that it built. *See D.R. Horton—Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006), pet. denied). The masonry work was completed by a subcontractor, but the subcontractor was not mentioned at all in the pleadings in the underlying lawsuit. The appellate court adhered to the "eight corners" rule and refused to admit D.R. Horton's extrinsic

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evidence that would have entitled it to coverage as an additional insured under its subcontractor's policy. *Id.* at *5. Thus, the court of appeals ruled that no duty to defend existed. In addition, just like the appellate court in *Pine Oak*, the court of appeals in *D.R. Horton* held that a finding of no duty to defend necessarily means that no duty to indemnify ever can exist. *Id.* at *6.

Commentary:

The Supreme Court of Texas' decision in *Pine Oak* is another monumental case with significant ramifications. Importantly, while the Court once again failed to recognize any exception to the "eight corners" rule, it did not necessarily foreclose the adoption of a limited exception for "coverage only" facts. Rather, it merely found a way to bar the evidence presented by Pine Oak, stating that it would contradict the allegations of the facts pleaded by the plaintiff in the underlying lawsuit.

Presumably, the Court may still recognize a limited exception for "coverage only" facts. Take the following scenario: A homebuilder like Pine Oak or D.R. Horton could be sued by a homeowner, who alleges that faulty work was performed by the homebuilder *and* its subcontractor, but the homeowner does not specifically name the subcontractor at issue. In that case, introduction of extrinsic evidence in order to supply the name of the subcontractor at issue should constitute "coverage only" evidence that does not contradict the allegations asserted or overlap with the liability facts. Instead, the evidence would merely replace the general term "subcontractor" with the specific names of such subcontractor. A similar situation has occurred in the past and been found acceptable. *See Int'l Serv. Ins. Co. v. Boll*, 392 S.W.2d 158 (Tex. Civ. App.—1965, writ ref'd n.r.e.) (finding that the petitions filed against a father for an accident occurring while his son was driving the car did not trigger a duty to defend because the father's only son was Roy Hamilton Boll, who specifically was excluded from coverage, even though Roy was not mentioned in the pleadings at issue). Provided that the homebuilder seeks to introduce the evidence in order to trigger coverage—as opposed to defeat its liability to the homeowner—the evidence should be allowed as "coverage only" evidence.

The most disturbing aspect of the Court's opinion in *Pine Oak* and its denial of petition in *D.R. Horton* is the ruling that no duty to defend necessarily means no duty to indemnify. In this author's opinion, such a ruling simply is wrong. In both cases, the actual facts established that the defective work at issue was performed by a subcontractor. The duty to indemnify, in contrast to the duty to defend, is based on the *actual* facts. Accordingly, even if the Court adheres to a strict eight corners approach for determining the duty to defend, nothing should have prevented Pine Oak or D.R. Horton from using the extrinsic evidence to establish a duty to indemnify.

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The Court's ruling, despite lip service to the contrary, conflates the duty to defend and the duty to indemnify. A better stated rule would be: When no duty to defend exists, and no facts can be developed at the trial of the underlying lawsuit to impose coverage, an insurer's duty to indemnify may be determined by summary judgment at the same time as the duty to defend. In effect, the Court's ruling in *Pine Oak* and its denial of petition in *D.R. Horton* places too much emphasis on the oft-recognized principle that the duty to defend is broader than the duty to indemnify. While that principle is true in most cases, it *does not* hold true in every case. Both *Pine Oak* and *D.R. Horton* are perfect examples of where a strict adherence to an "eight corners" rule defeated a duty to indemnify even though extrinsic evidence would have established coverage.

GETTING TO KNOW LEE H. SHIDLOFSKY AND THE INSURANCE LAW PRACTICE GROUP . . .

Lee H. Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is Secretary of the Insurance Law Section and holds a council position in the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Lee has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007 and 2008, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal. Lee recently was elected a Fellow of the Texas Bar Foundation.

Douglas P. Skelley and Melissa L. Kelly are associates at Visser Shidlofsky LLP. They each represent and counsel corporate policyholders in numerous insurance law matters. Doug and Melissa are members of both the Insurance Law Section and the Construction Law Section of the State Bar of Texas.

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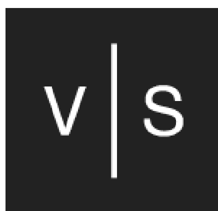

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